

The shadow economy should be included in credit rating calculations for European countries

In today's uncertain investment environment, the reliability of sovereign risk indicators is key.

Miroslava Kostova Karaboytcheva and **Carolina Silva** argue that, in spite of the clear link that has been drawn between the informal economy of a country and its sovereign risk, this aspect is still not taken into enough account. They propose a way of improving credit ratings estimation by involving a new factor: the shadow economy as a percentage of GDP.

Few are those economists or politicians who could have imagined in advance the macroeconomic changes that have been taking place since the beginning of the last global economic crisis. In the early 2000s, it was unthinkable that some EU countries would come close to the economic, social and political collapse they have recently been experiencing. The public debt of many of them increased and their financing became more and more costly at the same time that their credit ratings got worse. In such an uncertain economic environment, taking investment decisions becomes a particularly complex task.



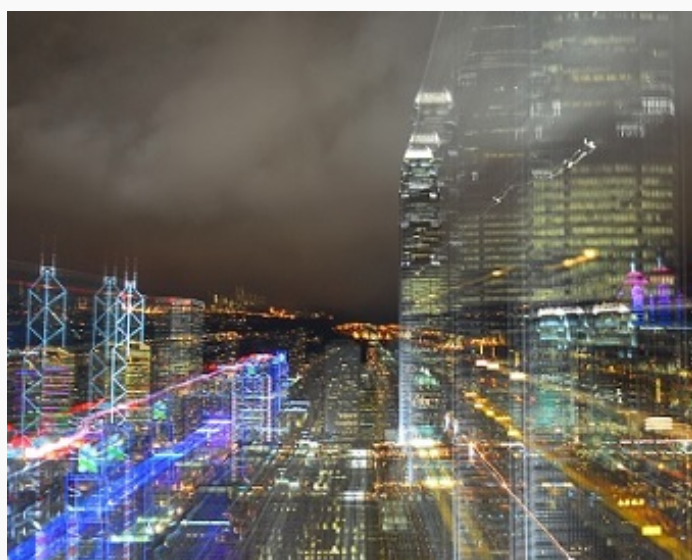
The reliability of sovereign risk indicators is crucial as it helps investors identify their optimal investment decisions. Thus, we propose a way to improve credit ratings estimation by involving new factors such as the shadow economy as a percentage of GDP.

Nowadays there are still large informal economies in the EU. Recent data show that the shadow economy in the EU-27 has increased in absolute value, although as a percentage of GDP it has decreased slightly in the past few years. Studies in this area prove that the bigger the size of the shadow economy in a country, the higher the tendency to experience greater volatility in economic activity cycles.

Studies have found a positive relationship between the size of the shadow economy and the amount of public debt. Therefore, a larger shadow economy will generally be linked to a bigger public debt, which in

turn is linked to a higher probability of sovereign default, and, thus, to greater financial instability. In 2008 there were just two EU countries whose public debt was close to 100 per cent of GDP: Italy and Belgium. In 2012, there were ten with debts close to or above 100 per cent of GDP (Belgium, Ireland, Italy, Greece, Spain, France, Hungary, Austria, Portugal, and the UK). Public debt has increased in all EU countries since the beginning of the crisis and the credit ratings of most of them have become worse.

Some old EU Member States (Denmark, Finland, Germany, Netherlands, Sweden, United Kingdom, Austria, France, Belgium and Ireland) have, in general, high credit ratings and small shadow economies as a percentage of GDP. However, some new Member States (Estonia, Slovakia, Slovenia, Bulgaria, Latvia, Lithuania, Croatia, Romania, Hungary and Poland) have lower credit ratings and larger shadow economies.



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In a [recent study](#), we tested the significance of the shadow economy in the estimation of the sovereign risk ratings. We included variables used by credit rating agencies such as GDP per capita, real investment, unemployment rate, general government gross debt, fiscal revenues, fiscal expenditures and fiscal Interest expenditures, to which we added the shadow economy as a percentage of GDP. We found that countries with low sovereign risk improve their credit rating when we include the estimate of the shadow economy as a percentage of GDP. On the contrary, countries with higher sovereign risk see that their ratings altered negatively when the shadow economy is taken into account because they have, in general, a relatively large unofficial economy.

Despite the evident relationship between a country's performance and its underground economy, the latter has not been considered yet by credit rating agencies as a relevant factor when computing their sovereign risk estimations. Credit rating agencies provide information to big companies and governments regarding the likelihood that a country will repay its loans; therefore, they become particularly relevant in times of economic uncertainty.

Ratings agencies have been strongly criticised for inaccurate ratings since the beginning of the global financial crisis. There is no agreement whether this is due to a lack of competence or to a conflict of interests. In this respect, a regulation of credit rating agencies in the EU came into force in 2009 as the agencies play a key role in financial markets and their ratings are taken into consideration by investors, borrowers, institutions and governments in order to take financial decisions. It is useful to comprise indicators whose importance have not yet been taken into account and could be positive for investment results.

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